Concluding Remarks

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Chapter 1 began with an overview of the policy issues ranging from management of the macroeconomy to banking policy and which included a review of the debate over the relationship between economic development and development of the financial sector. From this broad perspective, the chapter sought to place the arguments presented in this volume within the wider debate about the Asian currency and financial crises. The chapter also argued that any debate over financial and economic policies has to be undertaken from an overall perspective that is fully cognizant of the mutual relationships that exist among policies.

A country seeking to develop economically has to strengthen the workings of its financial sector. Financial liberalization policies were introduced with the intent of achieving the desired strengthening; instead these policies led to financial crises. The banking sector is fundamentally weak at protecting itself against bank runs (Diamond and Dybvig 1983). As financial liberalization progressed, competition increased; this lowered the strength of banks along with their franchise value, which made moral hazard in bank management an all the more serious problem.

Macroeconomic instability becomes the cause for a macro shock which banks cannot protect themselves against by dispersing their loans over a large number of borrowers. Therefore it is important to maintain macroeconomic stability in order to prevent financial crises. But according to the argument of the trilemma in an open economy, in an environment where international capital transactions can be freely conducted, monetary authorities have only limited ability to stabilize either exchange-rate fluctuations or interest-rate fluctuations. In effect this means that financial liberalization decreases the ability of governments to maintain macroeconomic stability.

On the other hand, if a government chooses to regulate the transaction of international capital, this will put constraints on the procuring of capital needed for economic development. It will also restrict the competitive environment of the financial industry.

When there is a failure to prevent a financial crisis, banks react by reducing credit (a credit crunch) and companies reduce their borrowing. Both of these actions become substantial impediments to the stability of the macroeconomy.

In this way policies are interrelated, and because of this, policymakers have to give due consideration to the way their various policies are combined. When the Asian currency crisis broke out, the IMF sought to stabilize currency values through high interest rate policies, which meant abandoning interest rate stability. This was one of the choices of the trilemma. However, when demanding the implementation of this policy, the IMF should have given much more thorough consideration to the adverse impact of high interest rates on the stability of the macroeconomy and on the danger of causing a financial crisis. Most of the countries hit by the Asian currency crisis suffered large-scale falls in their rates of economic growth, and the fact that a number of countries suffered severe financial crises suggests strongly that the high interest rate policy of the IMF approach put too little value on the interrelating effects that policies have on one another.

According to the argument of the trilemma, if a government chooses to give up interest rate stability, it should be able to achieve exchange-rate stability. However, the IMF's high interest rate policy was carried out at the same time that exchange-rate intervention was abandoned with the result that neither exchange rates nor interest rates could be stabilized. Chapter 2 of this volume undertook a dynamic analysis using a Dornbusch overshoot model (1976) to examine the reason for this outcome.

According to the IMF, when the market loses confidence in a country's economy, this raises the risk premium on foreign exchange transactions. In order to stabilize the foreign exchange market, the country will have to raise interest rates to match the rise in risk premium. Looking at this situation, the model analysis in Chapter 2 examined the dynamic effects of high interest rate policy under the assumption that the long-term equilibrium real exchange rate depreciated. The analysis showed that it was possible to stabilize the exchange rate temporarily through high interest rate policy. However, the nominal exchange rate gradually depreciated until its value reached the level consistent with the equilibrium real exchange rate. In the Asian currency crisis as well, even though high interest rate policies were in effect for up to a year, nominal as well as real exchange rates slowly declined. This situation conforms much more to the model analysis in this volume than to the explanations of the IMF.

When the long-term equilibrium exchange rate is depreciating, as discussed above, and a high interest rate policy has been adopted, this policy can always be abandoned, and it was shown that the uncertainty caused by this possibility becomes a factor magnifying risk premium. Thus high interest rate policy itself can have the ironic effect of creating the very problem it is attempting to counter.

High interest rate policy also has a bad effect on the financial sector, especially the profitability of banks, and there is the danger that it can bring on a financial crisis or worsen an already existing one. In Asian countries bank financing plays a central role in providing funds to companies, therefore the adverse impact of high interest rate policy on the banking industry has an especially severe effect. Chapter 3 compared the bank-based financial system with its market-based counterpart, undertaking a theoretical analysis of the factors that form the bank-based financial system in Asian countries (and in developing countries in general).

When undertaking financial transactions there is usually the problem of an asymmetry of information. To overcome this problem and have the financial system develop, there has to be a process where financial institutions themselves collect information or where systems and support institutions develop which can provide information services. In developing countries with their limited human and economic resources, it is more rational to adopt a bank-based financial system where the financial institutions themselves have the incentive to collect information, rather than trying to set up systems and foster supporting institutions for information gathering which are necessary for developing financial markets.

Most of the Asian countries have developed bank-based financial systems. But it seems that this bank-based system was a factor that worsened the bad effects of the financial crisis. A financial crisis can be expected to have a negative impact on the balance sheets of banks and other financial intermediators, but beyond this such a crisis also hurts the efficiency of financial operations because it retards the timeliness of fresh information concerning risk about borrowers which is needed for the efficient functioning of the bank-based financial system.

The failure to take an overall perspective and synthesize the many policy issues has not been a fault of the IMF alone. The principal methodology of economics and of science in general is to take an object of study and subdivide it and abstract from it in order to delve more deeply into the observation and examination of the object. This has been an extremely effective method for accumulating knowledge. However, this methodology can also constrict perspective and cause the failure to synthesize the examined parts into an interconnected organic whole.

The chapters in the second half of this volume analyze the problem of coping with financial crises. Within the sphere of financial theory, the debate about financial crises has almost entirely dealt with the issue of "how to prevent a crisis," while the problem of "how to deal with a crisis once it has occurred" has received only secondary treatment. It could be that this lopsided debate is related to the above-mentioned "constricted perspective" that can afflict economic research. When there is a failure to prevent a financial crisis, the reluctance of banks to lend and of companies to borrow can upset the stability of the macroeconomy. Because of the lack of interest in the mutual relationship between macroeconomic instability and a reluctance to lend and borrow, the focus of attention has only been on the phenomenon of financial crises, which has focused debate on the mechanisms that give rise to such crises and on the related issue of how to prevent such crises.

Besides the small amount of existing research on the problem of coping with financial crises, another difficulty is the lack of consensus over any good prescription for overcoming these crises. The discussion in Chapter 4 centered on the keywords "ex ante" and "ex post" and provided an introduction for the analyses in Chapters 5 and 6. The chapter also pointed out that worsening corporate financial conditions caused by a financial crisis distorts corporate behavior; this distorted behavior brings about reduced corporate investing which becomes a factor for the instability of the macroeconomy. Chapter 4 also dealt with corporate-debt-restructuring policy as a part of remedial policy in Asian countries in the aftermath of the currency crisis.

Based on Chapter 4's introductory discussion, Chapter 5 took up the issue of government bank-bailout policies. The chapter utilized the concept of time inconsistency to analyze the problem of moral hazard which can arise from government efforts to rescue banks. As already pointed out, the debate to date has been dominated by the argument of how to prevent financial crises, and this argument has tended to put too much concern on the issue of moral hazard arising from bank bailout policies. This undue concern has lent support to the idea that however hard it is on economic stability, the best policy is to let banks fail today in order to prevent banking crises in the future.

However, as shown in Chapter 5, under certain circumstance bank-bailout policies can be a rational choice as the best option among second-best choices.

Such circumstances tend to arise more easily in developing countries; and to unduly stifle the adoption of bailout policies can only lead to a fall in the level of social well-being while not necessarily lessening the possibility of banking crises occurring in the future. Therefore, what is needed first are measures fostering institutional changes that can bring change to the costs and benefits of the government's bailout policy. Only then, does the problem become one of dealing with the issue of time inconsistency.

Such institutional changes include the structure of the social safety net needed to cope with a crisis of the financial system. For example, there need to be measures put in place so that the failure of an individual bank and its liquidation process do not bring on a crisis for the whole financial system. Also necessary is maintaining a stable macroeconomic environment by upgrading the institutions that conduct economic and financial policy and by pursuing policies that foster development of the financial market.

However, when undertaking bank bailout policies, due care has to be taken to guard against moral hazard in the banking sector and conflicts of interest within the concerned administrative offices of the government. These problems are examined in the latter half of Chapter 5 as they relate to the policies taken in the different countries following Asia's currency crisis and to the institutional arrangements that have come into being with post-crisis financial restructuring.

Finally Chapter 6 closes this study with a theoretical analysis of the corporate debt restructuring that has taken place since the Asian currency crisis. The rise in agency costs as a result of worsening corporate financial conditions has increased corporate costs for procuring external funds. This has made companies reluctant to borrow. Usually the restructuring of corporate debt changes the capital structure of a company, and the way this affects agency costs is one criterion for evaluating a company's debt-restructuring program. Debt-equity conversions are often undertaken, but these are not always the most desirable method to use. Certainly debt-related agency cost can be reduced through debt-equity conversions, but this can also raise the agency cost of issuing stock because of the dilution in the shares held by the controlling stockholders who own the management rights to the company. In effect, there is no single approach to corporate debt restructuring. Various methods have to be used together in skillful combination and in ways that are appropriate for dealing with the conditions affecting the individual company. But whether individual companies have debt-restructuring programs or not, institutional reforms that promote the establishment of a legal system able to deal with bankruptcies and that encourage better corporate governance have the overall effect of lowering agency costs.

The Asian currency crisis that broke out in 1997 was the first such crisis of the post–Cold War era during which the globalization of economies and financial markets progressed at a rapid pace. It would be fortunate if such crises and their ramifications for our globalized markets could be prevented in the future. But macro shocks still occur, and a financial crisis can break out with great unexpectedness, as happened in 1997. Globalization means that a financial crisis in one part of the world can have far-reaching adverse effects; the crisis that started in Thailand in 1997 ultimately affected countries as far away as Korea and Brazil. Thus more than just attempting to prevent these crises, what is needed is focusing attention on coping with currency and financial crises ex post and developing the tools and methods for overcoming them after their occurrence. The present volume has been published with this latter intent in mind and with the hopes of shifting the debate on financial crises toward these latter objectives.